

SIX PROBLEMS
WITH
PRIVATIZING SOCIAL SECURITY

*Prepared by the Office of Congressman Bob Matsui
and the Democratic Staff of the Committee on Ways and Means, March 7, 2002*

SIX PROBLEMS WITH PRIVATIZING SOCIAL SECURITY

- Privatization would increase financial risk for Social Security beneficiaries.
- Privatization would require severe cuts in Social Security benefits.
- Privatization would harm women.
- Privatization would harm minorities.
- Privatization would undermine Social Security disability and survivors' benefits.
- The fees for administering a privatized system would eat away at the value of workers' accounts and would significantly reduce the payments they would receive from them.

RISK

Social Security privatization would expose individual workers and their families to much greater financial risk. Under privatization, Social Security benefits would no longer be determined primarily by a worker's earnings and the payroll tax contributions he or she made over his or her career. Rather, benefit levels would be determined by the vagaries of the stock market, by a worker's skill (or luck) in making investments, and by the timing of his or her decision to retire.

- Social Security today provides guaranteed, lifelong benefits. No matter what the stock market does the day you retire or in the months leading up to your retirement, your benefit will be unaffected.
- Advocates of individual accounts argue that, since fluctuations in the stock market average out over time, individual investment risk is negligible. Averages are misleading. For every person whose investments perform above average, there is another person counting on Social Security whose investments perform below average. Retirees are not just averages. Retirees are individuals.
- Between March 2000 and April 2001, the S&P 500 fell by 424 points or 28 percent. If Social Security had been privatized, a worker who had his or her individual account invested in a fund that mirrored the S&P 500 and who retired in April 2001 would have 28 percent less to live on for the rest of his or her life.
- There were fifteen years in the past century (1908-12, 1937, 1939, 1965-66, 1968-1973) in which the real value of the stock market fell by more than 40 percent over the preceding decade. (Congressional Budget Office)
- Between January 1973 and September 1974, the stock market declined by 43 percent and did not return to its 1972 high for almost 10 years. (Boston College Center for Retirement Research). More recently, the S&P 500 fell 10 percent in 2000 and 13 percent in 2001.
- Social Security protects against many risks, including the risk of death or disability, the risk of low lifetime earnings, the risk of unexpectedly long life, and the risk of inflation. Privatization undermines these protections and adds one more risk that workers would have to worry about – individual financial risk.

BENEFIT CUTS

Social Security operates largely on a pay-as-you-go basis. The vast majority of the payroll taxes paid by current workers are used to make payments to current beneficiaries, whether retirees, survivors, or the disabled. Consequently, if less money were to go into Social Security, there would be less money to pay benefits. The 3 plans in the December 2001 report of the President's Commission to Strengthen Social Security and a June 2000 report¹ by The Century Foundation (TCF) both reveal that even partial privatization of Social Security means substantial benefit cuts.

- Over the next 75 years, Social Security faces a projected financing shortfall equal to roughly two percent of taxable payroll. Diverting just 2 percentage points of the payroll tax into individual retirement accounts would necessarily increase that shortfall to nearly 4 percent of taxable payroll.
- The TCF calculated that closing this gap of nearly 4 percent of taxable payroll would necessitate benefit cuts of 41 percent if such cuts were imposed uniformly for all beneficiaries aged 55 and younger in 2002. Older workers would experience smaller reductions if the cuts were phased-in, but workers aged 30 and younger in 2002 would see cuts of up to 54 percent. Workers between the ages of 55 and 35 would suffer benefit reductions of 25 to 46 percent under a phased-in scenario. (See appendix for additional details.)
- Among the commission plans, one called for diverting 2.4 percentage points of the current 12.4 percent payroll tax from the Social Security Trust Funds into individual accounts, reducing the amount of money available to pay for Social Security benefits by \$1.5 trillion between FY 2003 and FY 2012. Even the commission's smallest plan, with a diversion of 1.33 percentage points, would drain the Trust Funds of \$1.2 trillion over the next 10 years.
- In order to pay for privatizing Social Security, the commission proposed cutting benefits for future retirees by 30-46 percent, reducing disability and survivor benefits, raising the retirement age, and drawing on general revenues. It did not specify which taxes would be raised, or which other spending would be cut, to raise the revenues required by the plans.
- The accounts would be voluntary, but the cuts are mandatory. The President and his commission have emphasized that the accounts would be voluntary. But the benefit cuts the commission proposes to make up for the loss of revenue diverted to the accounts would apply to all future beneficiaries, not just those who had an account.

¹ *Governor Bush's Individual Account Proposal: Implications for Retirement Benefits*, by Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag – four of the nation's leading experts on Social Security

PRIVATIZATION HURTS WOMEN

Women constitute the majority of elderly Social Security beneficiaries – approximately 60 percent of Social Security recipients over the age of 65 and roughly 72 percent of beneficiaries above the age of 85 are women. Women rely heavily on Social Security as a source of income in old age – 27 percent of women over age 65 count on Social Security for 90 percent of their income. Yet, Social Security privatization would undermine many of the features of the program that benefit women the most.

- Women, on average, earn less than men, meaning that they count upon Social Security's progressive benefit structure to ensure that they have an adequate income in retirement. (The progressive benefit structure means that lower earners have a higher proportion of their pre-retirement earnings replaced by Social Security than higher-earning workers.)
- Women are less likely to be covered by an employer-sponsored pension plan. Hence, Social Security comprises a larger portion of their total retirement income.
- Since women lose an average of 14 years of earnings due to time out of the workforce (to raise children or to care for ailing parents or spouses), and since women generally have a higher incidence of part-time employment, they have less opportunity to save for retirement.
- Women live 6 to 8 years longer than men do, so they must make retirement savings stretch over longer periods of time. Consequently, women depend upon Social Security's life-long benefits, which are fully protected against inflation.
- Individual account balances and the annual benefits they yield are the direct result of a deposit into an individual account and any return on the investment. Because women earn less and spend less time in the workforce, they would have less to deposit. Because women live longer in retirement, they would have to stretch out the payments from their accounts over more years. In short, women would have to live on smaller benefits from smaller accounts.
- No privatization proposal can prevent individual account balances from being eroded by inflation. This is particularly devastating for women, who have less money to retire on and need to make their money last longer. Social Security resolves this problem by adjusting benefits each year through an automatic cost-of-living adjustment (COLA) that is tied to the annual increase in the Consumer Price Index, the official measure of inflation.

PRIVATIZATION HURTS MINORITIES

Social Security is the single most important source of income for African-American and Hispanic retirees. On average, it provides about three-quarters of their retirement income. For 1 in 2 African-American or Hispanic seniors, Social Security benefits provide 90 percent or more of their total income. Privatization jeopardizes the protections that are of particular importance to people of color:

- Social Security provides insurance against the risk of having low lifetime earnings. It has a progressive benefit formula that provides higher benefits, relative to earnings, for low-wage earners than for high-wage earners. This is an important feature of Social Security for many members of minority groups. Median earnings for African-Americans were about \$15,000 in 1996; for Hispanics the median was \$14,000. The median for the general population was \$19,000. Under privatization, lower-wage workers would lose part of the extra boost provided by Social Security's progressive structure. This is because individual savings accounts – which are based on a flat percentage of earnings (i.e. a non-progressive structure) – would be substituted for Social Security benefits – which are calculated on a progressive basis.
- Retirees who are minorities are more likely to depend heavily on Social Security to provide retirement income. Only 28 percent of African-American retirees, and 21 percent of Hispanic retirees, have a pension other than Social Security. They have little to fall back on should Social Security benefits be reduced as a result of privatization.
- The median income of African-American seniors is modest – in 1998, it was less than \$8,000 for singles, and about \$22,000 for married couples. For Hispanic retirees, median incomes are even lower – \$7,800 for singles and \$17,200 for couples. With such modest budgets, the guaranteed monthly benefit provided by Social Security is especially important, since there is little room to cut should income drop unexpectedly – as could happen with private investment accounts.
- Social Security provides disability and survivors benefits that are unmatched in the private sector. This protection would be undermined in a privatized Social Security system. These benefits would have to be cut to pay for the accounts, yet the accounts would be unable to make up for the loss of these benefits. Disability and survivor insurance protection is especially important for African-Americans, who have higher rates of career-ending disability or premature death. African-Americans comprise only 12 percent of the U.S. population, but account for 17 percent of the Social Security disability beneficiaries.
- Social Security is family insurance. Those who are financially dependent on a breadwinner who dies, becomes disabled, or retires are entitled to receive benefits. These include the spouse, minor children, and adult children who were disabled as children. It would be difficult for an individual savings account to provide the same degree of income security to a workers' dependents that Social Security does today, because there would only be a fixed pot of money to meet the needs of all dependents. Social Security's family benefits are particularly important to African-American families: nearly one-fifth of all African-Americans who receive Social Security benefits are children.

IMPACT ON DISABILITY AND SURVIVORS BENEFITS

Social Security is more than just a retirement program. As of December 2001, 13.8 million people – or about 30 percent of all Social Security beneficiaries – were receiving Social Security benefits because they or a family member are severely disabled or because a family member has passed away. Moreover, it is estimated that a twenty-year-old today has a 1 in 6 chance of dying before reaching retirement age and a 3 in 10 chance of becoming disabled before reaching retirement age, making survivors and disability insurance just as important in the future as they are today.

- For a 27-year-old worker with a spouse and two children, Social Security provides the equivalent of a \$403,000 life insurance policy or a \$353,000 disability insurance policy. The vast majority of workers would be unable to obtain similar coverage through private markets.
- In 1996, only 26 percent of private-sector employees had long-term disability coverage under employer-sponsored insurance plans. (GAO)
- In the case of retirement benefits, workers would accumulate balances in their individual accounts over their entire careers. In the case of survivors and disability benefits, balances would accumulate over much shorter periods of time and would, therefore, provide much less income in the event that a worker dies or becomes disabled.
- In January 2001 after examining a number of privatization plans, the GAO concluded, “the income from [workers’ individual accounts] was not sufficient to compensate for the decline in the insurance benefits that disabled beneficiaries would receive.”
- The President’s Social Security commission recommended cutting disability benefits to help pay for the cost of private accounts. Also, it barred access to the accounts prior to retirement age. This represents a double blow for disabled workers – reduced Social Security benefits, and no money from the accounts to cushion the loss.
- If the survivors and disability insurance elements of the program were insulated from benefit cuts, then much larger cuts in retirement benefits would be necessary to achieve the same overall level of cost reductions – reductions which are necessary because of the loss of the Trust Funds’ revenue to the individual accounts.

COST OF ADMINISTERING AND ANNUITIZING A PRIVATE SYSTEM

Administering a privatized Social Security system would be an incredibly difficult and complex task, the cost of which would have a significant impact on workers' retirement security. In the words of the Employee Benefit Research Institute, "Adding individual accounts to Social Security could be the largest undertaking in the history of the U.S. financial market, and no system to date has the capacity to administer such a system."

- Under a system of private accounts, workers would likely lose between 20 to 40 percent of their accounts' value to administrative charges and management fees.
- An annual fee equal to 1 percent of assets under management would absorb 20 percent of a worker's individual account over the course of a 40-year career.
- An annual fee of 2 percent would eat up 40 percent of a worker's account during his or her working years. According to Investment Company Institute data from late 1998, the average administrative cost for mutual funds is 1.49 percent per year.
- Administrative costs under the United Kingdom's voluntary individual account system reduced the account balance of the typical worker by 36 percent (relative to the balance that would have accumulated without any administrative costs).
- Social Security administrative costs equal less than 1 percent of the value of benefits, compared to the 20 to 40 percent for individual accounts. Unlike private investment funds, which charge their costs against an individual's account, Social Security's administrative costs have no effect on benefit levels.
- Workers' account balances would be further reduced by the cost of purchasing an annuity. Social Security provides a guaranteed stream of benefit payments for as long as a retiree (and his or her spouse) lives. To replicate this stream of life-long benefits and to ensure that they do not outlive their individual account balances, workers would need to purchase an annuity with their individual account balances. In a report issued in 1999, the General Accounting Office found that the cost of purchasing an annuity could consume up to 15 percent of workers' account balances (on top of any losses due to the other administrative costs described here).
- The administrative costs of a system of individual accounts would depend on a number of factors, including the extent to which fund management was centralized, the range of investment options available to workers, the level of customer service offered under such a system (e.g. telephone access to account information, frequent account balance statements, etc), and the rules and regulations governing the accounts. As advocates of individual accounts have rarely discussed any of these details, it is difficult to determine how expensive it would be to administer the accounts they envision.

SOCIAL SECURITY PRIVATIZATION WOULD LEAD TO BENEFIT CUTS OF 54 PERCENT FOR YOUNG WORKERS

In June 2000, The Century Foundation (TCF) released a report entitled *Governor Bush's Individual Account Proposal: Implications for Retirement Benefits*. Written by Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag – four of the nation's leading experts on Social Security – the report finds that, if 2 percentage points of the current 12.4 percent payroll tax were diverted into individual retirement accounts, Social Security benefits would have to be cut by 54 percent for workers aged 30 and younger in 2002 in order to restore Social Security's long-term solvency. The following explains how TCF's report reaches that 54 percent figure:

- Over the next 75 years, Social Security faces a projected financing shortfall equal to roughly two percent of taxable payroll.
- Diverting 2 percentage points of the payroll tax into individual retirement accounts would necessarily increase that shortfall to nearly 4 percent of taxable payroll.
- This shortfall can be closed in only one of four ways: (1) by raising payroll taxes, (2) by investing a portion of the Social Security Trust Funds in equities, (3) by transferring general revenue into Social Security from non-Social-Security surpluses, or (4) by cutting Social Security benefits.
- Since President Bush has repeatedly ruled out the first two options and his tax and budgetary policies make the third impossible, TCF's report assumes a 2-percentage point privatization plan would have to be accompanied by sizable benefit cuts in order to achieve long-term solvency.
- TCF's report calculates that closing a gap of nearly 4 percent of taxable payroll would necessitate benefit cuts of 41 percent, if such cuts were imposed uniformly for all beneficiaries aged 55 and younger in 2002. If cuts were phased-in, such that older workers experienced smaller reductions, benefits would have to be cut by 54 percent for those workers aged 30 and younger in 2002. Workers between the ages of 55 and 35 would suffer benefit reductions of 25 to 46 percent under a phased-in scenario.
- TCF's report assumes that survivors' benefits would be subjected to the same level of cuts as retirement benefits. Yet, President Bush claims, as one of the principles for his Social Security Commission, that he will "preserve Social Security's disability and survivors components." If survivors' benefits were insulated from benefit cuts, much larger cuts in retirement benefits would be necessary.
- It should be noted that the 54 percent figure for Social Security benefit cuts does not include any payments from workers' individual accounts. However, TCF's report finds that even when the proceeds of individual accounts are included, single average wage workers aged 30 and younger in 2002 would experience a loss of retirement income of 20 percent, relative to current-law Social Security benefits. Low-wage workers and married couples would be even worse off. According to TCF's report, they could experience overall benefit reductions of up to 38 percent.